



Testimony of
Thomas J. Duesterberg
President and Chief Executive Officer
Manufacturers Alliance/MAPI Inc.
on
“The Impact of Regulation on U.S. Manufacturing”
Before the
Subcommittee on Regulatory Affairs
Committee on Government Reform
U.S. House of Representatives
April 12, 2005

Madam Chairman and Members of the Subcommittee. My name is Tom Duesterberg, and I am here in my capacity as President and Chief Executive Officer of the Manufacturers Alliance/MAPI, a membership organization representing some 450 firms predominantly from the manufacturing sector. The Alliance is the leading executive development and economic research organization serving the manufacturing sector. Our activities range from management and policy research to economic forecasting and to the operation of some 30 executive councils and conferences for senior executives in nearly every major management discipline. My remarks today draw on a number of our studies and books issued in the last few years examining the competitive pressures on U.S. manufacturing firms in an increasingly globalized economy, and on direct feedback from the 2,000 senior executives who participate in our programs.

Introduction: The State of U.S. Manufacturing in 2005

It is widely recognized that the manufacturing sector is exposed to competition from around the world and that the scope and quality of this competition is constantly growing. The manufacturing sector is nearly four times more exposed to international competition than the much larger services sector.¹ Despite the hugely successful efforts of manufacturers to respond by improving productivity and accelerating the pace of their quality improvements and product innovation, international competition from developing countries, led initially by the four tigers of East Asia, later by Mexico and Brazil, and now by the emerging economic superpowers of China and India, has taken a toll on the ability of firms to survive and prosper. The headline numbers of a loss of 2.9 million manufacturing jobs since the dawn of the new millennium, and the growth of a trade deficit that now stands between \$600 billion and \$700 billion on an annual basis, are testimony to the difficult competitive landscape. The steady growth of global manufacturing capacity, and the willingness of global competitors to put market share before profits, puts a lid on any price increase by domestic

¹ This is calculated on the basis of the sum exports and imports in both goods and services as a proportion of total GDP in the United States. If only imports are included, the manufacturing sector would be some 10 times more exposed.

firms even when their input costs increase. Many nations, especially our main East Asian competitors, also keep the value of their currencies artificially low. In this environment, manufacturers are especially sensitive to their cost structures in relation to their global competitors, and any costs imposed by, or related to, regulation become a factor in their ability to survive.

Before exploring the impact of regulatory costs in greater detail, a bit of historical perspective is in order. After the Second World War, U.S. manufacturing was globally dominant and grew steadily along with the world economy. In the 1960s and 1970s, Western Europe and Japan resumed their pre-war position as capable competitors to U.S. industry. To this landscape was added, gradually over time, new manufacturing powers in East Asia and parts of Latin America. With the cost problems and inflation associated with the oil crisis of 1973 through 1981 added to the strong challenge from Japan and the four tigers, many in the United States began to fear the “hollowing out” of domestic industry. Particularly hard hit were traditional manufacturing symbols such as steel and autos. But U.S. industry, aided by sound monetary policy and the low-tax, deregulatory environment of the 1980s, responded successfully. In the 1990s, the creative genius of American innovators and entrepreneurs was unleashed by technological innovation, a stable domestic policy environment, and strong global growth. With the flowering of new industries like information technology, communications, and biotechnology, manufacturing grew much faster than the overall economy and was indeed its principal engine for growth.²

The first half of the 21st Century, however, has witnessed the evolution of a much more difficult competitive landscape. The double-dip manufacturing recession that stretched from 2001 into 2003 was the longest (in this sector) since the Great Depression of the 1930s. The rise of China and other developing country export powerhouses, disruptions due to terrorism and its aftermath, rising energy and commodity prices, deflation of the technology bubble, and the poor performance of the European and Japanese economies, all contributed to the long downturn in U.S. manufacturing.

We can point to a number of indicators which begin to give a picture of the new competitive landscape. A good place to start is with longer term data on the creation and distribution of manufacturing plants and jobs in the United States.³

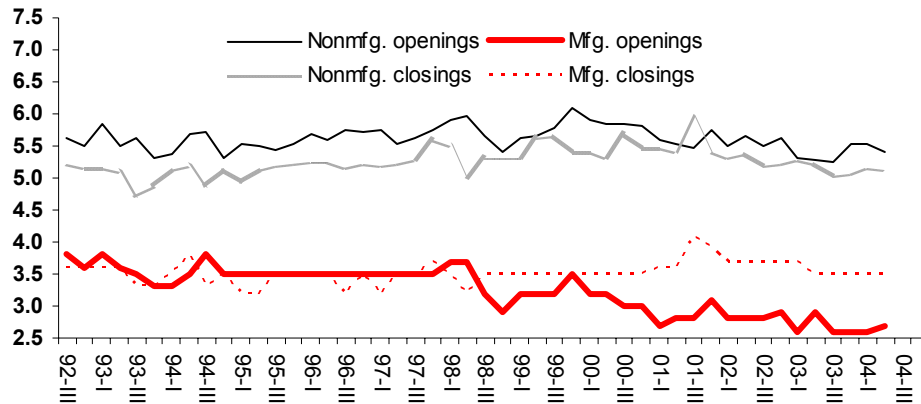
The relentless forces of creation and destruction, first described by Joseph Schumpeter, can be measured in the numbers of plant openings and closings over the past four decades. Data collected by the U.S. Department of Commerce show remarkable stability in both creation of new plants and their destruction between 1967 and 1997. Before 1998, we consistently saw about 52,000 plant openings annually. Consequently, between 1967 and 1998, the total number of plants operating in the United States grew from around 310,000 to 375,000. But, in the new millennium, the number of new startups dropped off to an average of 36,000 to 40,000 per year. Plant closings remained stable from 1967 to the present, at a rate of slightly more than 50,000 per year. In contrast, the number of new establishments in the nonmanufacturing sector grew by 848,000 since 1994, in sharp contrast to the loss of 23,000 manufacturing plants in the same time frame. The turning point for manufacturing was around 1998, as the total count of operating manufacturing plants dropped by about 9 percent after this year, for a cumulative loss of some 35,000 plants. Chart 1 shows plant openings and closings since 1992.

This decline cannot be explained by the undeniable fact that some plants have been moved abroad. We do not have fully comparable data regarding plant openings and closings abroad by U.S. manufacturing firms. We do, however, know that between 1999 and 2002, the total number of foreign manufacturing subsidiaries of U.S. firms grew by only 250, while the number of plants located in the United States fell by over 20,000.

² See Thomas J. Duesterberg and Ernest H. Preeg, *U.S. Manufacturing: The Engine for Growth in a Global Economy* (New York: Praeger, 2003).

³ For a fuller discussion of this trend, see Daniel J. Meckstroth, *The Dynamic Nature of the U.S. Economy: The Churn of Firms and Jobs*, Manufacturers Alliance/MAPI, February 2005.

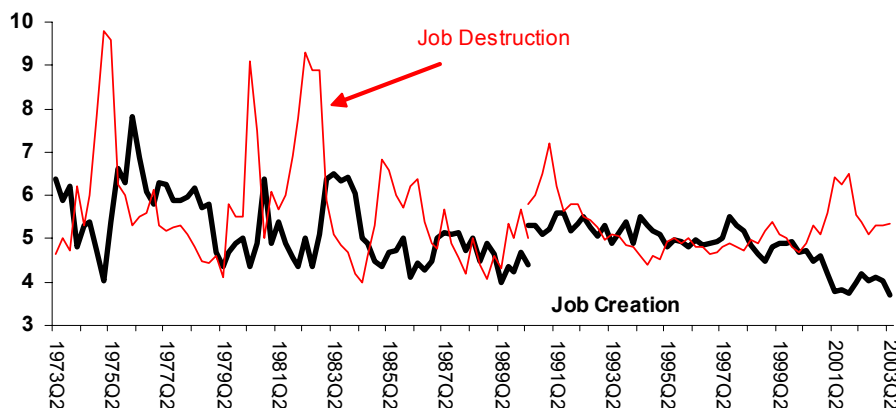
Chart 1
Establishment Openings and Closings By Industry
 Seasonally Adjusted Quarterly—1992 III to 2004 I



Source: U.S. Department of Labor, *Business Employment Dynamics Survey*

The manufacturing labor market shows a similar pattern to that of plant openings, as shown in Chart 2. The recession of 2001-2003 in manufacturing saw the worst job performance in this sector since the Great Depression. While about 2.9 million jobs were lost, only about 100,000 have been regained in manufacturing since the recovery began. In six of the past seven months, we have seen job losses in the manufacturing sector. It is the anemic rate of new hires, the counterpart to low levels of new plant openings, that explains the huge loss of manufacturing jobs. Despite a solid recovery in production to previous peak levels by late 2004, employment remains 15 percent below its total at the start of the recession. At this point in the average recovery characteristic of the post-World War II era, we could expect a loss of only 4 percent of manufacturing jobs.

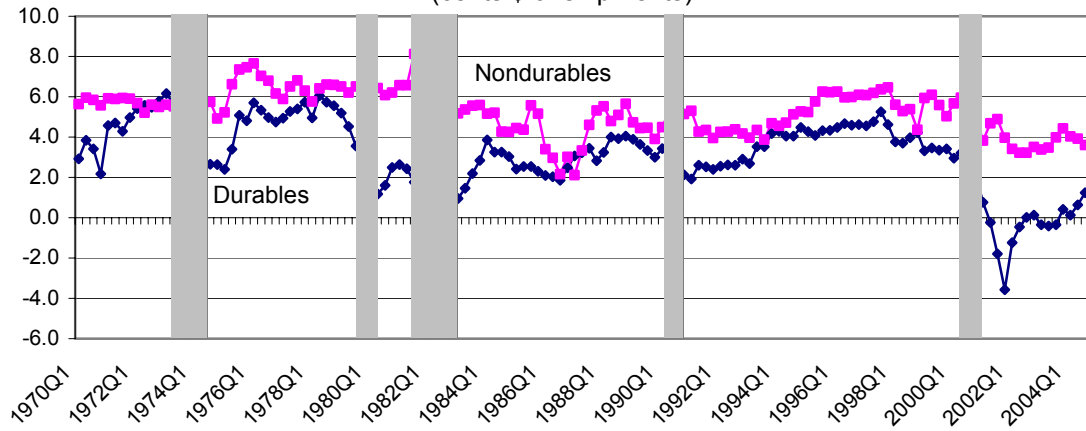
Chart 2
Job Creation and Destruction in Manufacturing
 Not Seasonally Adjusted 1990 II to 2003 II
 (Percent of total jobs)



Source: Jason Faberman

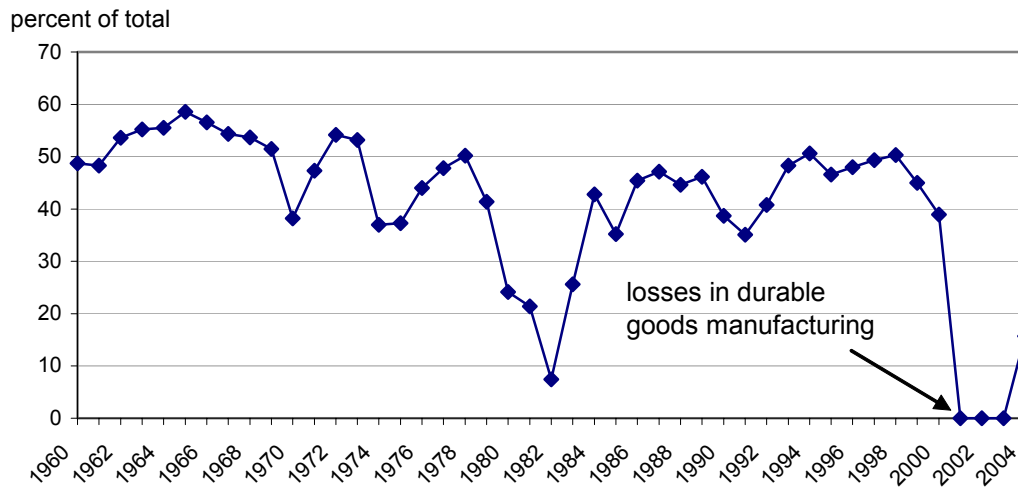
This shift in a long-term pattern of plant openings and job creation dates back to at least 1998 and has continued through the recession and current recovery. Two other disturbing patterns also seem to date back to the late 1990s. First, profits in manufacturing, especially in the durable goods sector—which is the real strength of American manufacturing in terms of technical innovation and productivity growth—have been trending lower in the last decade, as Charts 3 and 4 indicate.

Chart 3
Durable and Nondurable Manufacturing Profit Rate
 (cents/\$ of shipments)



Source: U.S. Bureau of Economic Analysis (profits) and U.S. Bureau of the Census (shipments)

Chart 4
Durable Goods Industry Profits as a Percentage of Total Manufacturing Profits, 1960-2004

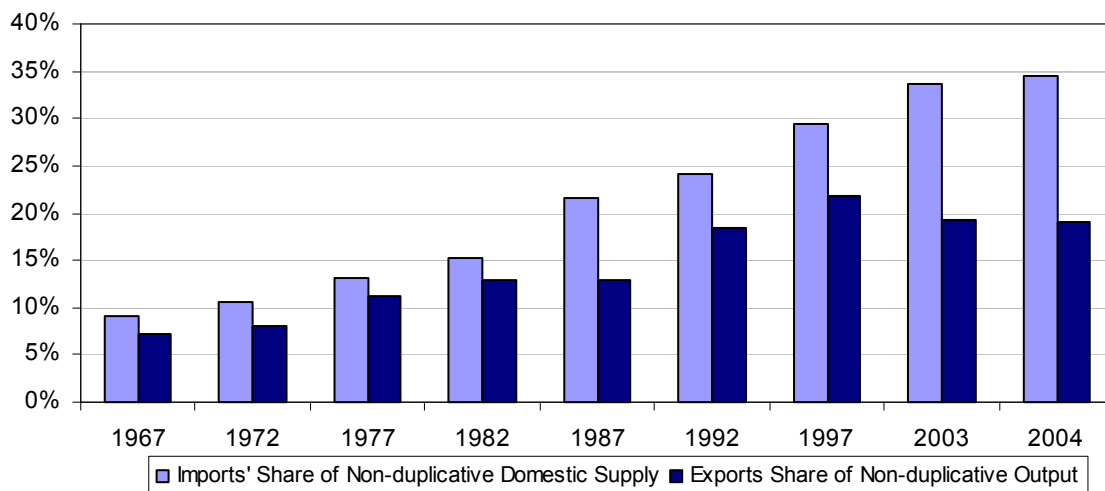


Source: U.S. Department of Commerce, Bureau of Economic Analysis

In the 1980s and 1990s, profits in the manufacturing sector were much higher, as a percent of all corporate profits, than the sector's share of the total economy. While manufacturing represented some 17 percent to 18 percent of total value added in the U.S. economy in 1987, it provided 24 percent of total profits. By 2003, manufacturing provided roughly 14 percent of total output but only 7 percent of profits.

Second, the trade deficit in the goods-producing sector has continued to grow despite the recession earlier in this decade, despite a fall in the value of the dollar against some trading currencies such as the euro, and despite huge gains in productivity which have led to stable-to-lower unit labor costs among U.S. producers. Last year, the trade deficit in goods reached nearly \$666 billion, 22 percent larger than in 2003. Even more noteworthy is the growing deficit in so-called “advanced technology products” (ATP), such as computers, aerospace, automation equipment, and pharmaceuticals, which clearly ought to be the growth industries of the future in our sophisticated, innovative, and research-oriented economy. In 1998, we had a \$32 billion trade surplus in these products. By 2002 we experienced our first deficit in ATP trade, and last year the deficit grew to \$37 billion. Altogether imports have grown from about 9 percent of domestic supply in 1967 to 35 percent in 2004. Export performance has not lost pace; exports were 7 percent of domestic output in 1967, reached a peak at just over 22 percent in 1997, and fell back to under 19 percent in 2004, as Chart 5 shows.

Chart 5
**Growth of Imports and Exports in Manufacturing as
a Share of Domestic Production**



What can explain this rate of new plant openings and hires so far below historical patterns and the structural decline in our balance of trade and in profits in manufacturing? Rapid productivity growth and working off excess capacity from the ebullient 1990s in the manufacturing sector certainly account for some hesitancy in new risk-taking, and thus in decisions to hire and open new plants. Import penetration has grown from 29 percent to 35 percent of the domestic market since 1997, reflecting enhanced competition from China. Nonetheless, in the midst of a global synchronized boom, a falling dollar, and strong global demand for capital equipment—a U.S. strength—other factors are at work to sap the willingness of corporate executives to assume the risks attendant to building new plants and hiring new workers, and to erode the competitive advantages of our high-technology industries which flowed from several generations of technological leadership and steady investment in research and development.

Structural Cost Pressures

One place to start in trying to understand this secular decline is research by my colleague Jeremy Leonard which shows that a combination of cost pressures from energy, health care, tort litigation, corporate taxes, and regulation raises the base price of U.S. manufacturing by more than 22 percent

over raw labor costs alone, when compared to our nine leading trading partners. Such structural costs, when added onto already generous (by global standards) U.S. labor costs, greatly complicate the job faced by corporate executives in convincing their boards and their shareholders to put new money at risk. Table 1 summarizes the basic findings of this study.

Table 1
**Effect of Key “Overhead Costs” on Raw Cost Index
of Nine Largest U.S. Trading Partners, 2002**
(U.S. dollars per hour)

	United States	Average of nine partners	Canada	Mexico	Japan	China	Germany	United Kingdom	South Korea	Taiwan	France
Raw cost index	24.30	19.30	27.57	8.11	16.92	5.34	29.60	28.30	23.96	16.41	26.50
<i>Difference relative to U.S. costs in percent</i>											
Corporate tax rate	—	-5.6%	-3.4%	-6.0%	2.0%	-15.0%	-0.4%	-10.0%	-10.3%	-15.0%	-5.7%
Employee benefits	—	-5.5%	-4.8%	-9.4%	-9.4%	-12.6%	3.6%	-5.1%	9.0%	-11.5%	10.7%
Tort costs	—	-3.2%	-3.1%	N/A	-3.3%	N/A	-0.7%	-3.4%	N/A	N/A	-1.3%
Natural gas costs	—	-0.5%	-6.0%	-2.3%	12.5%	-2.3%	0.6%	2.1%	4.1%	15.3%	-4.2%
Pollution abatement	—	-3.5%	-2.8%	N/A	-2.3%	N/A	-2.4%	-3.0%	N/A	N/A	-1.5%
<i>Manufacturing production costs relative to the United States accounting for differences in overhead costs (dollars per hour)</i>											
Effective cost index	24.30	16.02	22.46	6.19	16.64	3.50	29.77	23.14	22.67	12.85	25.77

Source: Jeremy Leonard: *How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten*

ote: Data for tort costs and regulatory compliance costs are limited to the industrialized partners. Conservativ

Our study started with raw unit labor costs in the United States and its nine leading trading partners, expressed in dollar value. These include both high-cost producers—Germany, Canada, France, and the United Kingdom—and low-cost producers such as China and Mexico. When comparative data for costs from taxes, natural gas energy inputs, benefit costs, tort litigation costs, and environmental regulation as an average for the nine countries are factored in, the result is equivalent to adding more than \$3.00 per hour to the labor cost disadvantage of the United States. As Jim Berges, President of Emerson, and sponsor of our study, concluded:

U.S. manufacturing has demonstrated the ability to overcome pure wage differentials with trading partners through innovation, capital investment and productivity. But when the structural cost multipliers Leonard describes in this paper are piled on, the task becomes unmanageable even for best-in-class companies. . . .⁴

Since we first published our structural cost study in 2003, some of the input costs we analyzed have become even more burdensome for U.S. producers. For example, benefits costs in the United States continue to escalate at an alarming rate. Between 2000 and 2004, total benefits costs as a share of total compensation grew from 31.6 percent to 35.1 percent. Health care costs remain the primary driver of this escalation, rising from 7.2 percent in 2000 to 8.4 percent of total compensation

⁴ See Jeremy A. Leonard, *How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness*, National Association of Manufacturers and Manufacturers Alliance/MAPI, December 2003, p. iii.

costs in 2004. Employer-paid contributions to pension plans, albeit a smaller share of total compensation, grew even faster than health care costs. Workers' compensation costs have also grown substantially in this period, despite the fact that injury and illness rates in manufacturing have declined by 25 percent.⁵

Taxes are among the most important policy-related, structural costs; and in this arena, too, the international competitive environment has trended against U.S.-based producers. Despite the helpful reduction in corporate income tax rates for manufacturers in 2004, many global competitors continue to be aggressive in lowering their corporate income taxes and providing tax incentives for local production. The headline case recently is Germany, which has announced its intention to lower the corporate income tax rate by roughly 20 percent, thus effectively ending its opposition to tax competition and opening the door to further tax cuts throughout the European Union.

The gravity of the situation with regard to higher corporate taxation in the United States was underscored by Paul Otellini, President of Intel, in testimony before the President's Advisory Panel on Federal Tax Reform. Intel is the world's largest semiconductor company, a leader in high-technology research and innovation, and a company that has retained 75 percent of its production in the United States. But Otellini argued that Intel's next generation microprocessor facility would save up to \$1 billion over 10 years by locating in one of many lower-tax venues outside the United States.⁶ Otellini cited the need for lower corporate tax rates and permanent extension of the research and innovation tax credit. If, as Otellini argues, we are in danger of losing research-based, high-technology operations to foreign locations due to tax policy, then the entire U.S. manufacturing base is likely to be threatened.

Because of intense foreign competition in the goods-producing sector, manufacturers have little ability to raise prices when their own costs of production increase. Given this difficult competitive situation for the manufacturing sector, any additional burden related to policy, which by definition is a controllable cost by society but not by individual companies, is problematic. I would like to focus today on four major areas where the ongoing thrust of regulation is particularly harmful to the manufacturing sector. Much of the debate over regulation tends to focus on the thousands of discrete, important, and oftentimes costly regulations that, while in many cases helpful in achieving agreed social goals, add to the cost of building products in the United States. Too often, however, we forget that government policies which affect the entire economy or major subsectors are equivalent to regulation on a large scale, and have commensurately greater impact. The four areas I will touch on today are: energy regulation; telecommunications regulation; new corporate regulation resulting from the Sarbanes-Oxley Act; and the relatively new phenomenon of regulation by litigation. This last issue is one of the most dangerous, because it often results from the actions of the judicial branch, promoted by private parties and state attorneys general, and not subject to the normal oversight by elected officials. Other sectors, of course, are highly regulated and important to the future of high-technology manufacturing in the United States, such as medical products, but time does not permit a full exploration of the relevant issues.

Energy Regulation—Natural Gas

The U.S. manufacturing sector is the largest user of energy resources in our economy. Given the daily attention to the record costs of energy, especially oil, but also including natural gas and electricity, it is not easy to recall that, for much of the 19th and 20th Centuries, U.S. industrial might was driven by abundant and (relatively) inexpensive supplies of energy. Just a few decades ago, entire industries in the United States were globally dominant in part due to our natural endowment of energy. Primary metals production—including aluminum which depended so heavily on hydropower

⁵ See Jeremy A. Leonard, *Pressures on Manufacturing Costs: It's More Than Health Care*, Manufacturers Alliance/MAPI, March 1, 2005.

⁶ See Paul Otellini, "Impact of Taxes on U.S. Semiconductor Company Decisions." Testimony Before the President's Advisory Panel on Federal Tax Reform, San Francisco, California, March 31, 2005.

and nuclear power—chemicals, plastics, glass, paper, and metalworking industries all thrived in an era of energy abundance. U.S. automakers, too, thrived in an era of low energy prices. The current, high price environment is a result of both enhanced global competition for resources, and of domestic regulation which impedes the production, transformation, and transmission of domestic (or North American) resources. The situation is most critical, and most directly related to policy, in the arena of natural gas production.

Since 1998, average natural gas prices in the United States have risen over 300 percent. Demand has risen faster than for other energy resources largely because natural gas is the most environmentally friendly fossil fuel. Also contributing to the rise in price is the reality that natural gas is not easily transported from distant locations.⁷ Much of the demand growth resulted from government policy to promote the use of natural gas for electricity production. Between 1986 and 2002, consumption for this purpose grew by 215 percent and is expected to continue its upward path. At the same time, production in the United States has trended lower, falling by 5 percent in the new millennium. Canadian imports have also fallen for a variety of reasons, not the least of which is diversion to local uses such as inputs to the massive projects to recover oil from tar sands in Western Canada. Domestic production in the United States has been discouraged by the many political choices to limit exploration in environmentally sensitive areas and to limit construction of input facilities for liquefied natural gas (LNG).

The resulting supply/demand squeeze explains the huge increase in natural gas costs that affects both consumers and industrial production facilities. The manufacturing sector is especially hard hit because it accounts for about 34 percent of total natural gas consumption. This is especially important because U.S. prices are now significantly above those of major competitors—for example, average U.S. prices are more than 25 percent greater than in Europe, which imports significantly more natural gas than does the United States. Alan Greenspan recently contrasted LNG import prices in Europe, between \$2 and \$4 per million Btu, and Japan, between \$3 and \$5, with a consumer price over \$6 in the United States.⁸ Moreover, unless there is a significant change in policy, prices for natural gas could grow by another 80 percent by 2020.

Almost all manufacturers use natural gas in one form or another, but it is especially important as a preferred heat source in the glass and metal-forming industries. It is, of course, absolutely critical to the chemicals and plastics industries as both a raw material and a heat source. Whereas oil prices are generally set in global markets (and priced in dollars), natural gas markets are more localized and price differentials across countries are significantly greater than for oil or coal.

As an input to the chemicals and plastics industries, natural gas represents about two-thirds of the feedstock in the United States. Oil accounts for the other third. In Europe the proportions are reversed. Hence, the local price disadvantage for natural gas is leveraged in the chemicals and plastics industries vis-à-vis European competition, where prices have been more stable and more natural gas is used.

Recent data on production and international trade in chemicals highlights the deterioration in the terms of trade for this industry. For example, natural gas is the most important cost component for manufacturing nitrogen fertilizer (also known as anhydrous ammonia). Domestic commercial production of ammonia fell from 16.6 million tons in 1999 to just 9.5 million tons in 2001 as a result of higher natural gas prices and weather-related decreases in demand. Exports of ammonia fell from 0.924 million tons for the fiscal year ending June 30, 2000 to 0.576 million tons for the year ending June 30, 2003. Over the same period, ammonia imports rose from 4.7 million tons to 7.3 million

⁷ For a detailed summary of this issue, see Donald A. Norman, *Liquefied Natural Gas and the Future of Manufacturing*, Manufacturers Alliance/MAPI, September 2004.

⁸ Alan Greenspan, Remarks Before the National Petrochemical and Refiners Association Conference, San Antonio, Texas, April 5, 2005.

tons. In addition to worsening the trade balance, higher fertilizer prices raise the cost of farming and, ultimately, food.

For the chemical manufacturing industry as a whole, the balance of trade swung from a trade surplus of \$16.1 billion in 1997 to a trade deficit of \$11.2 billion in 2003 as higher gas prices reduced the competitiveness of domestic producers.⁹ The deficit was reduced somewhat in 2004 to an estimated \$6.8 billion as global demand rose strongly. Not surprisingly, employment in this technologically sophisticated and innovative industry decreased by over 100,000 between 2000 and early 2005. This loss represents 10 percent of total chemical industry employment in 2000.

Other industries vulnerable to higher natural gas prices include iron and steel and the aluminum industry because of their high gas and electricity use. Anecdotal evidence highlights the challenges higher natural gas prices pose for specific companies. Natural gas costs for PPG Industries, a global supplier of paint, glass, fiberglass, and chemicals, increased 50 percent from 2002 to 2003.¹⁰ Dow Chemical announced that because of higher gas costs, it would reduce its workforce in North America by 3,000 in 2004 after cutting 3,500 jobs the previous year.¹¹ A Dow spokesperson pointed out that the prices the company pays for natural gas currently are \$2.05 to \$3.08 per thousand cubic feet (Mcf) cheaper in Europe than in the United States.¹²

There are several ways to address what can only be called a crisis in domestic natural gas costs. One is through increased domestic production, perhaps in conjunction with imports from energy-rich Mexico and Canada. Another is through the use of other abundant domestic resources—coal, nuclear, wind—for generating electricity, hence taking the pressure off natural gas for new production. Finally, the Alliance supports increased imports of LNG as the best *near-term* solution to the crisis.¹³ New facilities can be brought on-line within two to three years of regulatory approval, at economically competitive prices. Under conservative assumptions for new LNG import facilities, we believe that the current price of natural gas could be *lowered* by 25 percent over the next 5 to 10 years, with an enormous benefit for manufacturers.

There are, of course, many other ways to reduce regulatory impediments that increase the price of energy, including electricity. One trade-off for *not* taking some of these measures is a punishing cost disadvantage for American manufacturers and continued job destruction and loss of market share in important sectors such as chemicals and plastics.

Telecommunications Regulation

Telecommunications regulation has been highly contentious since the birth of the industry over 100 years ago. In recent decades the industry has been one of the most important in terms of growth, technological innovation, and centrality to the information economy. Success in this sector is vital to the modern economy and also to national security. Although the United States has been and remains among the world leaders in this sector, its performance lags in important international comparisons. The ability of domestic producers (and the service providers who are the largest purchasers of telecommunications equipment) to thrive is closely tied to the regulatory environment, as this sector remains among the most highly regulated of all American industries.

⁹ International Trade Commission, U.S. Department of Commerce. Data pertain to the chemical industry as categorized by NAICS code 325.

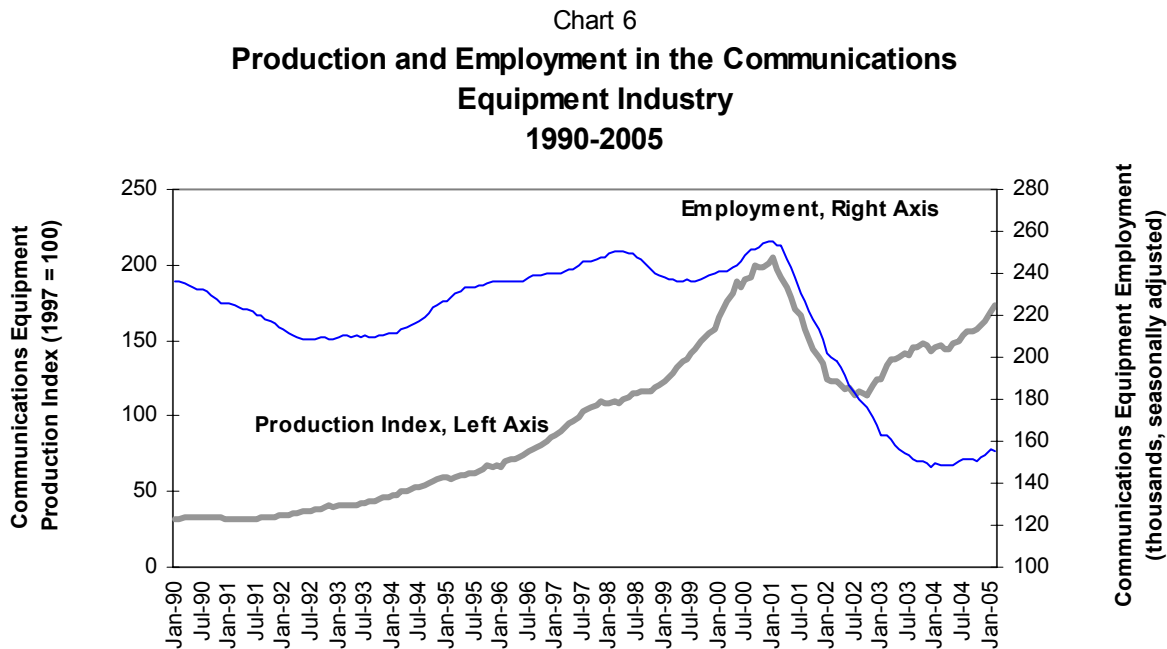
¹⁰ “Chemical, Farming Industries Detail Price Woes,” *Platts Gas Daily*, March 26, 2004, p. 1, www.platts.com.

¹¹ “High Gas Costs ‘Wreak Havoc’ on Manufacturers,” *Platts Gas Daily*, July 2, 2004, p. 1, www.platts.com.

¹² *Ibid.*, p. 6.

¹³ Norman, *Liquefied Natural Gas*, *op. cit.*, p. 25.

The story of telecommunications over the past two decades is one of classic boom and bust. Due in part to the deregulation which started with the AT&T divestiture in 1984 and accelerated with the 1996 Telecommunications Act, the industry grew at a dizzying pace in the 1990s. Technical innovation, especially in the essentially new industries of cellular telephony and Internet data transmission, also helped contribute to an unprecedented boom in this industry. As Chart 6 indicates, the 1990s saw a more than 500 percent increase in U.S. production of communications equipment. In late 1999 into mid-2000, new orders in this sector grew by an astounding 73 percent! In 2001 and the years that followed, this sector saw an almost equally precipitous decline. As production volumes plummeted by more than 60 percent, more than 80,000 workers, or one-third of the workforce, in the equipment industry lost their jobs.



Sources: Bureau of Labor Statistics, U.S. Department of Labor, and Federal Reserve Board

In the last few years, the United States has fallen behind global leaders in some measures of performance in the communications industry which is so central to the modern economy. From what was in 1997 a trade surplus of \$8.2 billion in communications equipment, we reached a trade deficit of \$5 billion in 2004. In terms of broadband subscriptions per 100 inhabitants, the United States ranks only eleventh among the OECD countries. It lags most European countries, Japan, and the Asian tigers in terms of wireless telephone subscribers. In March, the World Economic Forum announced that America fell from first to fifth place in a measure called its “Networked Readiness Index” covering the information and communications technology sectors.¹⁴

Despite the heady optimism unleashed by the Telecommunications Act of 1996, this sector has remained highly regulated and highly taxed, which are key factors explaining the collapse and slow recovery of the industry since mid-2000. Analyst Greg Sidak calculated that membership in the Federal Communications bar grew by 73 percent after the 1996 Act, driven by a tripling in the number of pages of regulations in the *FCC Record* and a 37 percent hike in the funding of the

¹⁴ Harold Furchtgott-Roth, “Our National Economic Insecurity,” *The New York Sun*, March 15, 2005.

agency.¹⁵ Both the FCC and state (in some cases local) governments retain a significant regulatory role over: allocation of electromagnetic spectrum; deployment and pricing of broadband services; pricing and service offerings of basic telephony providers; and services, pricing, and ownership of broadcast and cable television.

The telecommunications sector also remains one of the most highly taxed in the modern economy. Some of this is historic—such as the federal excise tax which dates to the time of the Spanish-American War, or the depreciation schedules which often predate the invention of modern digital switches—and some is more recent. For example, the 1996 Act called for a “universal service” program, which eager regulators have liberally interpreted as an open invitation to impose a tax on all telecommunications users. The tax has grown from 6.6 percent to 11.1 percent on certain interstate services in the new millennium, at a time when over 95 percent of the population already has telephone service. All told, the typical transition tax burden for telecommunications services is 18.17 percent, compared to an average of 6.12 percent for all industries.¹⁶ These taxes are **over and above** normal corporate income taxes.

This combination of ubiquitous (and growing) regulation and heavy taxation has put a damper on the capital investment and basic research needed to keep the United States in the forefront as a leader in the telecommunications industry.¹⁷ As Chart 7 shows, capital investment among telecom services providers fell by over 57 percent between 2000 and 2003. Almost one-third of the total jobs in the equipment industry have been lost since June 2000. The deployment of advanced services such as broadband, which are enablers for other industries such as the Internet, is lagging international competition. Valuable electromagnetic spectrum needed for expansion of broadband connectivity lies idle. The United States is in danger of ceding leadership in one of the marquee growth industries of the future. We need as a consequence to revisit the way we employ regulation and the related taxation of this industry. We need to free up broadband providers; make spectrum available to the most economic uses; recalibrate the tax structure affecting this industry, especially the various excise taxes and depreciation schedules; and find ways to promote domestic research and capital investment. We should not allow high-tech industries—especially those vital to national security—to go the way of the textile industry. Regulatory reform is a large part of the renewal process.

Regulation of Corporate Governance

One of the most effective responses to global competition is lean manufacturing and its various offshoots. This concept applies to management as well as to production functions. Senior corporate executives have broader responsibilities as their firms downsize, and the complexity of their work increases in direct proportion to the rapid pace of change which characterizes the modern goods-producing sector. It is in this context that we can try to understand the impact of the enhanced regulation of corporate governance resulting from the Sarbanes-Oxley Act of 2002 (SOX).

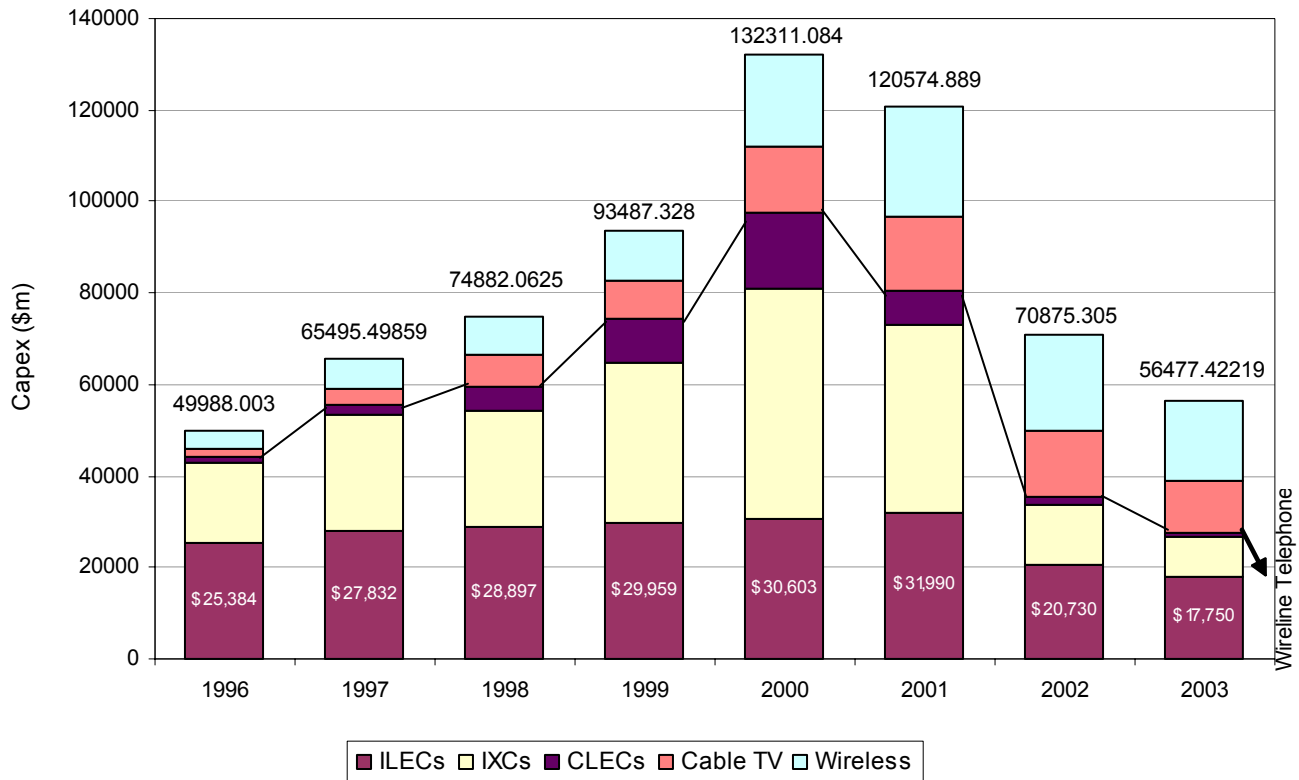
The serious breach of trust (and law) by executive malfeasance at high-profile companies such as Enron, MCI, and others over the past five years, along with a loss of confidence in corporate reporting after the market crash early this century, led to passage of SOX. Implementation of this new law has proven to be extremely costly, both in terms of the time devoted by senior executives to compliance with the Act and the added costs, both internal and external, necessitated by the new audit and control requirements. Through the more than 500 finance, accounting, and tax executives

¹⁵ As summarized by Adam Thierer, “The Non-Revolution in Telecommunications and Technology Policy,” in Chris Edwards and John Samples, eds., *The Republican Revolution 10 Years Later*, Cato Institute, 2005, p. 175.

¹⁶ See Telecommunications Tax Task Force of the Council on State Taxation, “2004 State Study and Report on Telecommunications Taxation,” 2005.

¹⁷ It is also costly to consumers; a recent study estimates that federal regulations cost consumers up to \$105 billion annually in higher prices and foregone services. See Jerry Ellis, *Costs and Consequences of Federal Telecommunications and Broadband Regulations*, Arlington, VA, Mercatus Center, 2005.

Chart 7
**Capital Expenditures by U.S. Telecom Service Providers:
 1996-2003**



Note: ILECs (Local Phone Companies); IXCs (Long Distance Carriers); CLECs (Competitive Local Exchange Companies)

Source: T. Rowe Price and Company Reports

participating in MAPI programs, we have been closely following management efforts to comply with SOX. We have done four separate surveys of the direct costs associated with implementation. At each successive iteration, these costs are multiplying. Our most recent survey of some 60 senior financial officers at medium to large companies on the costs of compliance with Section 404 is revealing. Key results are as follows:

- The cost of compliance for respondent companies, expressed as a percent of net income before taxes, averaged 5.9 percent. The median percentage was 4.1 percent. These percentages are high and indicate that the cost of 404 compliance has significantly impacted the bottom lines of many companies.
- External auditor fees for 404 compliance totaled an estimated \$110.2 million, almost as much as the \$124.2 million spent by the 54 respondent companies on the external financial statement audit excluding 404 attestations.
- The cost of compliance, including external audit fees, external (non-audit) assistance for compliance, and internal audit costs for 404 compliance totaled an estimated \$352.7 million for the 56 firms who participated in this survey.

- Most firms (42 out of 47 who responded) report that their audit costs for 404 attestations exceeded initial quotes. Of the 42 firms reporting that audit costs exceeded initial quotes, 63 percent reported that the excess was 50 percent or higher.
- Sixty-nine percent of the respondents say that the relationship between their company and its external auditor has deteriorated to varying degrees. The remaining respondents indicated “no change” (21 percent) or “improved” relations with their external auditors (10 percent).

It is quite startling to learn that the average cost of compliance at this sample of companies represented **5.9 percent of net income before taxes**.¹⁸ By any measure, not the least of which is the profit squeeze already affecting the globalized manufacturing sector, this represents a significant burden. Compliance costs may be even more burdensome for smaller companies and probably discourages them from going public. Thus, they are more isolated from our large and liquid capital markets.

Equally troubling is the time and energy needed by senior management to comply. Some large companies estimate that compliance with section 404 of SOX adds 100,000 man hours per year, with one company reporting 130 employees working full time on section 404.¹⁹ A recent study by executive recruiter Russell Reynolds Associates corroborates anecdotal evidence and testimony we have received from our members: “Increased pressure for regulatory compliance is driving more chief financial officers out the door.” The two main reasons for increased dissatisfaction and turnover in the ranks of corporate chief financial officers, according to the study, are SOX compliance and pressures to meet investors’ short-term earnings expectations.²⁰

Sarbanes-Oxley is a disheartening example of overregulation that puts American companies at an international competitive disadvantage. Advanced technology companies are probably hurt the most because they have to be flexible and constantly alert to the need to change and innovate to stay ahead of their competitors. SOX implementation saps their time and works to slow down decision making at all levels. SOX compliance not only takes enormous time, money, and energy from senior executives, their boards, and their firms, the Act also dangles the sword of Damocles over their heads with new criminal liability provisions. In summary, SOX compliance hits the bottom line of manufacturing firms hard, saps the time and energy of management which could be devoted to a creative response to globalization, and discourages risk taking.

Regulation Through Litigation

As if the threats to the competitiveness of U.S. industry posed by a civil justice system that has run amok, rising structural cost pressures, and a crippling burden of regulations were not enough, a disturbing convergence of these problems has been cultivated in recent years in the form of regulation through litigation. In addition to its anti-competitive impact on industry, this emerging problem represents nothing less than an effort to employ liability litigation in a manner that usurps Congress’s constitutionally mandated role in lawmaking.

The practice I am referring to involves the employment of private trial lawyers by state and local governments to conduct a coordinated litigation effort against an entire industry, purportedly for the purpose of attacking serious public health or safety problems.²¹ To date, these so-called government recoupment lawsuits have been brought against controversial, politically disfavored industries such

¹⁸ MAPI comments to the SEC on Sarbanes-Oxley were filed on March 31, 2005, as File 4-497. This provides a comprehensive review of compliance costs and constructive suggestions for changes to the SOX procedures.

¹⁹ “404 tonnes of paper,” *The Economist*, December 18, 2004, p. 116.

²⁰ See Erin White, “Call It Sarbanes-Oxley Burnout: Finance-Chief Turnover Is Rising,” *The Wall Street Journal*, April 5, 2005, p. B-4.

²¹ For a more detailed discussion of this problem, see Frederick T. Stocker, *I Pay, You Pay, We All Pay: How the Growing Tort Crisis Undermines the U.S. Economy and the American System of Justice*, Manufacturers Alliance/MAPI, Arlington, VA, 2003, Chapter 7.

as tobacco and firearms. Suits against such industries tempt socially activist judges into ignoring developed principles of civil law and establishing new theories of liability and duties based upon their individual public policy preferences. The problem is that courts which bend rules for controversial products set precedents that will apply equally to all industries. A situation results where governments are presented with a template to follow in suing other industries whose products or services—although they were legally sold and, at that time, may not even have been recognized as posing any health or safety risk—are now perceived to constitute some public harm that can only be alleviated through litigation.

In this type of litigation, state or local governments seek to recover considerable monetary damages for their claimed losses, as well as to force some changes in industry practices as a means of ameliorating a societal ill for which that industry is seen as having some responsibility. The sheer magnitude of potential damages is a major negotiating lever to induce an industry to change practices. In the case of the firearms suits brought by dozens of local governments in numerous jurisdictions, defense costs alone threatened to bankrupt an industry and served as a considerable inducement to settlement. In short, organizational changes that normally occur in response to state or federal legislation or regulations instead occur as a result of litigation initiated by pressure groups in search of victories in court that could not be achieved at the ballot box.

The lurking threat behind this trend is that yesterday's suits against the tobacco and firearms industries become today's suits against adult beverage, pharmaceutical, or even automobile manufacturers; the lead paint industry; the entertainment and gaming industries; and Internet providers or fast food restaurant chains. The list of industries that might be fertile targets for these suits that threaten their continued competitiveness is limited only by the ambitions of state and local politicians and the imagination of trial lawyers. The deep pockets of the target industry—not the underlying processes or products of the companies—are often the determining factor in this type of legal action.

Finally on this point, legislating public policy in the courts threatens the separation of powers doctrine and reveals an astonishing contempt for the democratic process and for elected legislators. I believe that the role of the legislature is to legislate and the role of the courts is to interpret the law. These distinct roles should not be confused by state and local legislators in the name of political expediency, by their trial lawyer partners seeking personal gain, or by an activist judiciary desirous of making a social statement.

Conclusions

In the face of relentless foreign competition, lack of pricing power due to that competition, zealous regulators and prosecutors, and difficult cost pressures (now magnified by high materials costs), the animal spirits of risk-taking in the manufacturing sector are themselves at risk, as witnessed by historic lows of plant and job creation. These conditions are exacerbated by falling profit margins and by a significant deterioration in the terms of trade. The role of regulation in this environment is crucially important. This includes not only the type of regulation at a macro level described above, but the thousands of specific and narrow-gauge regulations that manufacturers must contend with every day. We must do a better job of balancing the risks and rewards of regulation. We should not allow ourselves to despair, as if current conditions and trends are irreversible.

Fortunately, there are deep reservoirs of optimism among American executives, buttressed by the efficient creative genius of our best innovators and researchers. Moreover, the American legal, cultural, and business environment remains even today superior to that of many of our global competitors in nurturing the constant pursuit of innovation, change, and risk needed to succeed in the modern economy. These forces, however, urgently need assistance from our policy makers. A more rational tort and regulatory environment, better controls on health care costs, pro-growth energy and telecommunications policies, more openness and less mercantilism in international markets, a tax structure that does not penalize domestic production and encourages research and investment, and a

better educated workforce, all could contribute to a better environment for risk-taking and innovation. The rise of China and India represents the greatest challenge to manufacturers in recent memory, but also, with their enormous demand for new goods, the greatest opportunity for risk-takers emboldened and properly incentivized to meet the challenge.